

MINUTES OF THE INVESTMENT COMMITTEE OF THE
BOARD OF TRUSTEES OF THE EMPLOYEES' RETIREMENT SYSTEM
OF THE STATE OF HAWAII

JUNE 8, 2020

CITY FINANCIAL TOWER
201 MERCHANT STREET, SUITE 1200
HONOLULU, HAWAII 96813

Trustees present: Mr. Vincent Barfield, Chair
(via teleconference) Dr. Catherine Chan, Vice Chair
Mr. Emmit Kane
Dr. Genevieve Ley
Mr. Wesley Machida
Mr. Jerome Rauckhorst
Mr. Bennett Yap

Trustee absent: Mr. Craig Hirai

Attorneys present: Mr. Ivan Torigoe, Deputy Attorney General
(via teleconference) Ms. Elmira Tsang, Deputy Attorney General (audio only)
Mr. Clayton Zane, Deputy Attorney General (audio only)

Staff present: Mr. Thomas Williams, Executive Director
(City Financial Tower) Ms. Kanoe Margol, Deputy Executive Director
Ms. Elizabeth Burton, Chief Investment Officer
Mr. Aaron Au, Investment Officer – Illiquid Markets
Ms. Dale Kanae, Board Secretary
Ms. Lori Kim, Secretary
Ms. Diana Gomes, Secretary

Staff present: Mr. Anthony Goo, Investment Officer – Liquid Markets
(via teleconference) Mr. David Okamoto, Investment Officer – Credit
Mr. Howard Hodel, Investment Officer – Risk Management
Mr. Ian Wetzel, Investment Officer
Mr. Andrew Chen, Investment Specialist
Ms. Gerri Konishi, Member Home Loan Assistant (audio only)

Guests present: Mr. Colin Bebee, Meketa Investment Group, Inc.
(via teleconference) Mr. Neil Rue, Meketa Investment Group, Inc.
Mr. Chae Hong, Aon Hewitt Investment Consulting, Inc.
Mr. Jack Dowd, Aon Hewitt Investment Consulting, Inc.

Public present: Lindsay Saienni, Financial Investment News
(via teleconference)

CALL TO ORDER

A quorum being present (Chair Barfield, Vice Chair Chan and Trustees Kane, Ley, Machida, Rauckhorst and Yap), Chair Barfield called the Investment Committee meeting to order at 9:10 a.m. Chair Barfield read the following statement, “Motion to hold meeting without any members

of the public physically present and allowing Trustees and members of the public to participate by teleconference or other remote meeting technology, pursuant to the Governor of the State of Hawaii's Supplementary Proclamation dated May 18, 2020, in order to implement social distancing measures." On a motion made by Trustee Rauckhorst, seconded by Trustee Machida and unanimously carried, the Investment Committee meeting continued.

PUBLIC COMMENT PERIOD

Chair Barfield called for public comment. There was no public comment.

RECESS

No recess was taken, Chapter 91 proceedings were moved to the latter part of the Board of Trustees meeting.

RECONVENE

Chair Barfield continued the Investment Committee meeting.

**APPROVAL OF MINUTES
MAY 12, 2020**

On a motion made by Trustee Rauckhorst, seconded by Trustee Yap and unanimously carried, the Investment Committee approved the minutes of the May 12, 2020 meeting as presented.

**SUMMARY OF MAY 2020
INVESTMENT OFFICE ACTIVITIES:**

- MARKET OVERVIEW
- CURRENT STATUS OF ACTIVITIES OF THE INVESTMENT OFFICE
- RISK BUDGETING UPDATE

Investment Officer ("IO") Howard Hodel and Chief Investment Officer ("CIO") Elizabeth Burton presented an update on the market. IO Hodel presented market information for the month of May:

During May, there was a continuation of a strong rally in equities with both the U.S. and global markets up around five percent, reflecting optimism about the prospects for an economic recovery. Volatility declined a bit but remained high in virtually all markets. In May, oil prices increased from April's extremely low levels as reduced supply carried the market back into equilibrium with the reduced demand resulting from the economic shutdowns.

Tensions between the U.S. and China intensified throughout May due to China's conduct during the pandemic, technology transfers, and repression in Hong Kong, as well as U.S. national security concerns with China's dominance over key components of the U.S. supply chain.

Brexit is headed toward a resolution by the end of 2020 with negotiations taking place over the next several months resulting in a compromise deal expected during the fourth quarter.

Despite the recent surge in stock prices, the economic slowdown and growing unemployment from government mandated lockdowns has caused a severe global recession with uncertainty on how quickly economies will recover. Losses to U.S. personal and small business income have been partially offset by U.S. government stimulus and support programs, but this level of support is not sustainable, and the long-term impacts of government deficits created by shutdowns and government programs are uncertain.

The U.S. Federal Reserve took monetary actions during February and March by cutting the Fed Funds rate to near zero, and launching a bond buying program and new TALF (Term Asset-Backed Loan Facility) to bring liquidity into the financial system and support the markets for government-backed housing securities, Treasury instruments, corporate bonds, and other credit instruments. Due to these monetary actions, the U.S. Treasury yield curve fell by over 100 bps during 2020 to a very low level at the end of May, sloping gradually up from about 14 bps for the three-month to 1.41% for the 30-year. In the Overseas market, the various Central Banks continue to intervene in their capital markets to support and stimulate their economies as necessary, particularly the European Central Bank which intensified its bond buying program.

Other highlights for the month include:

1. The U.S. government took unprecedented actions by passing a \$2 trillion relief and economic stimulus package (CARES Act) and two other acts that provide funds to assist medical facilities, essential workers treating coronavirus patients, individuals suffering financially, and small businesses to keep workers employed.
2. During April, a fourth stimulus package totaling a half billion dollars was enacted to support small businesses, a coronavirus testing program, and hospitals.
3. At end of May, Congressional leaders were working on an extension of stimulus programs beyond the end of July. Presently, there is no consensus between the two political parties.
4. The European Union (EU) Commission proposed a 750-billion-euro recovery fund consisting of grants and loans for every EU member state, supplementing its initial 540-billion-euro rescue package.

CIO Burton gave an overview of her report as follows:

CIO Report

CIO Burton mentioned the team continues to work remotely for the months of May and June. Regular team meetings, discussions with managers as well as educational training is still taking place. The team's flexible work schedule allows for close to a 24-hour coverage.

The GDP fell by 4.8% for the 1st quarter and by 20% for the 2nd quarter.

CIO Burton described the US/China tensions as troublesome, discussed the ramifications of pressure on the Yuan throughout the summer.

The Equity markets are confounding and there is additional downside potential, but over the short-term should hold up. Current preference for

US over foreign stocks; however, US stocks are becoming more attractive than foreign stocks.

The US Economy formally entered a recession in February. In Hawaii and elsewhere, the unemployment numbers may be underestimated – numbers are likely much higher as many people may be dropping out of the labor market. CIO Burton feels the State unemployment numbers are inaccurate since they do not include people reentering the workforce.

Internal and external discussions continue with the team regarding additional Hawaii-specific investments.

Investment team is looking at other strategies to diversify the portfolio per new asset allocation approved in November. Considering the new current market environment, staff at the moment is evaluating which addition to the portfolio could be attractive now, with a focus on achieving the 7% long-term target return. We are also cutting costs with managers where possible.

CIO Burton also described the work being done on the risk budget, which will be presented later by Andrew Chen.

The ERS portfolio, by design, is more liquid than many of our peers. We have heard that some peers were forced sellers, needing to liquidate assets to meet margin calls; ERS did not have a liquidity issue. In addition, early discussions around performance with peers indicate that ERS has preserved value and outperformed on a relative basis, which leaves us with less to regain than peers with more flexibility and fewer losses to recoup. For May, it looks like ERS could end the year on a positive note.

Furthermore, CIO Burton stated that ERS' portfolio is performing as expected and is pleased with its performance. An encouraging surprise.

[End of CIO Report]

Investment Officer Ian Wetzel stated that progress continued in consolidating from two core real estate separate account managers to one. The remaining separate account manager oversees existing properties and continues to invest and look for additional opportunities. Target is \$550 million (in separate account) with ERS committing an additional \$50 million to the manager's core real estate debt fund, bringing the total commitment to \$600 million.

The core real estate long-term strategic allocation target is expected to increase due to 2019 A/L study results (pending IPS changes). Staff and consultant will assess any potential increase and incorporate it into future real estate strategic/pacing plans. Staff has also been working on various other IPS changes for real assets.

Staff continues to implement ongoing monitoring and oversight process of existing managers (reviewing quarterly reports, portfolio review calls, Limited Partner Advisory Committee (LPAC) participation, GP consent requests, etc.) in addition to reviewing updates from real estate managers on the Coronavirus (COVID-19) situation; and resulting impacts to the markets as well as the ERS' portfolio.

IO Wetzel mentioned the non-core real estate commitments is a \$130 million target (\$100M-\$150M range) for the 2020 pacing plan which is on track. Total commitments of \$90M (two funds) were approved for calendar 2020 with one fund (\$40M) approved in November 2019 (for 2020 plan) and a second fund (\$50M) approved in May. Staff/consultant identified other potential funds coming to market in 2020 consistent with the real estate strategic plan as well as identify top real estate funds for recommendation to the Board.

Investment Officer Aaron Au said staff and legal counsel have closed on four private equity commitments for a total of \$185 million. Final legal and business reviews are being conducted on three other opportunities which represent \$125 million of commitments for total deals closed and in process of \$310 million. These funds fall into the large- and mega-size buyout space and are consistent with the strategic and pacing plans approved by the Board of Trustees on November 2019 and July 2019, respectively. Two other investment funds are coming to market as well and if consummated, ERS would be well on its way to achieving target allocation of between \$550- to \$650- million for calendar year 2020.

IO Au continues to track the current economic stress being placed on the private equity portfolio and requested Hamilton Lane (HL) to prepare an exposure analysis of the ERS's portfolio. HL estimates an average quarterly return of negative 10.7% across the consultant's entire client base. Staff believes that the ERS' private equity portfolio will experience a smaller 8-9% decline for the first quarter ended March 31, 2020. Data is still being analyzed for the second quarter.

IO Howard Hodel explained that the \$2.4 billion CRO portfolio declined in value during May, as expected, as equity and credit markets continued to rally for the second straight month in a volatile environment for many markets. Two managers triggered a rebalancing on one day late in the month. CRO's ex-post annualized volatility is slightly over 12%, which is the anticipated long-term expectation, while ex-ante annualized volatility is around 15%.

Crisis Risk Indicators turned red in early March and remained that way until they returned to green in late May. The current allocation to the long Treasury portfolio is underweight, while trend and alternative return capture strategies are overweight. CRO at month-end remained long fixed income (increasing exposure) and the U.S. dollar (increasing exposure), while commodities (stable exposure) and equities (stable exposure) remained short. CRO has been negatively correlated to the rest of the ERS portfolio, which has reduced the volatility of the total

ERS portfolio, while adding value so far during both the 2020 fiscal year and the 2020 calendar year. The capital markets in May were unfavorable for all CRO strategies: duration, risk premia, trend and systematic macro strategies. Staff is in the process of reducing the number of trend managers from five to four.

IO Hodel continued to explain that staff is in the process of onboarding one new reinsurance manager, working closely with another manager to structure a separate account, and is continuing to review other managers.

CIO Burton along with IO Hodel is in the process of conducting due diligence on discretionary global macro, relative value, and arbitrage managers, consistent with the approved asset liability study. They are close to making recommendations and will cover in more detail at the next Board of Trustees meeting.

New investment options in pre-funding account are being deferred; the State of Hawaii and other employers are not in a position to advance contributions.

During the last week of May, ERS made an initial funding to one of the two TALF funds that were approved earlier in May using the April Board Resolution.

The VIX declined to an average of 30.9% (closing between 27.5% and 37.2%) for the month; however, the current level is still well above the long-term historical median level of 17.3%.

For the month, U.S. large-cap equities returned 4.5% as the number of new COVID-19 infections declined, and states began to reopen their economies; nevertheless, the U.S. continues to lead the world in number of COVID-19 cases and death.

Daily tracking of the ERS portfolio volatility performance during May fell from 18% the previous month to indicate an annualized volatility of 8.4% during May compared to 18% from the previous month, and is now in line with the level experienced over the past three years.

Staff is continuing to monitor potential, significant macro risks in each of the three major economic regions of the world, any of which could trigger another market correction.

IO Hodel gave a presentation on the Risk Budgeting Study. His presentation is summarized below:

There are three components of investment risk management:

- Identify and measure various market risks
 - Develop a risk management plan
 - Establish investment risk budgets
- Risk budgeting is the process of establishing risk targets for investments and allocating risk by investing capital.

- Risk is measured as volatility, particularly downside volatility.
- Risk targets are based on the desired portfolio return target, return capital market assumptions (i.e. returns, volatilities and correlations of investment opportunities) and the tolerance for risk.
- There is an overall risk budget (i.e. risk target for the whole portfolio and each investment component of the portfolio) and an active risk budget, which sets a risk target for deviations from benchmarks for the portfolio, components and managers.

Conclusions from the portion of the risk budgeting study completed to date include:

- ERS portfolio is IPS Strategic Target consisting of benchmarks, a desired rate of return, core investment beliefs and risk tolerance versus a desired target.
- The new IPS Strategic Portfolio has a lower total risk budget with more diversified sources of risk than the current portfolio.
- Diversifying Strategies reduce volatility and drawdown risk but produces a lower expected return.
- Principal Protection provides liquidity, stability of principal and reduces volatility from a steady income stream but provides a significantly lower expected return.
- The utilized active risk budget since the start of the ERS' risk-based allocation methodology in October 2014 has been 1.6% per year and contributed a cumulative 2.8% to performance, or about \$400 million.

Investment staff will do the following:

- Continue to analyze the IPS Target Portfolio using new data.
- Continue to monitor risk and capital allocations.
- Establish active risk budgets.
- Analyze utilization of active risk budgets.
- Analyze returns.
- Explore expanding the scope of the cash securitization overlay.

ENTER EXECUTIVE SESSION

On a motion made by Trustee Yap, seconded by Trustee Machida, and unanimously carried, the Investment Committee entered Executive Session at 10:00 a.m.

EXECUTIVE SESSION

EXECUTIVE SESSION, PURSUANT TO HRS § 88-27.5(A)(1) AND HRS § 92-5(A)(4), TO CONDUCT

DISCUSSIONS AND DELIBERATIONS RELATING TO, AND IF APPROPRIATE, TO MAKE A DECISION ON INVESTMENTS OR PROSPECTIVE INVESTMENTS BY THE SYSTEM THAT REQUIRE THE CONSIDERATION OF INFORMATION OR RECORDS THAT ARE EXEMPT FROM DISCLOSURE UNDER CHAPTER 92F, INCLUDING INFORMATION AND RECORDS THAT ARE PROPRIETARY INFORMATION OR CONFIDENTIAL BUSINESS INFORMATION, AND TO CONSULT WITH THE BOARD'S ATTORNEYS ON QUESTIONS AND ISSUES PERTAINING TO THE BOARD'S POWERS, DUTIES, PRIVILEGES, IMMUNITIES, AND LIABILITIES WITH RESPECT TO INFORMATIONAL UPDATES ON INVESTMENT MANAGERS REGARDING ORGANIZATIONAL CHANGES, UTILIZATION, AND INVESTMENT STRATEGY.

APPROVAL OF EXECUTIVE SESSION MINUTES – MAY 12, 2020

On a motion made by Trustee Rauckhorst, seconded by Trustee Machida and unanimously carried, the Investment Committee approved the minutes of the May 12, 2020, meeting as presented.

EXIT EXECUTIVE SESSION

On a motion made by Trustee Machida, seconded by Trustee Yap, and unanimously carried, the Investment Committee exited Executive Session at 10:07 a.m.

MEETING ADJOURNED

On a motion made by Trustee Rauckhorst, seconded by Trustee Machida, and unanimously carried, Chair Barfield adjourned the meeting at 10:08 a.m.

**REDACTED
SIGNATURE**

Elizabeth T. Burton
Chief Investment Officer

EB/dlg